

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

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74-2452

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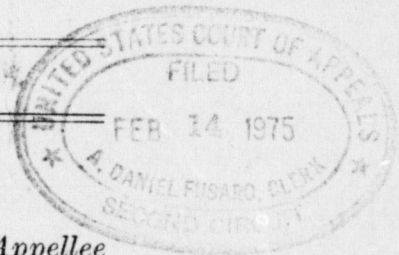
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IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

DIEMATIC MANUFACTURING CORP.,
Plaintiff-Appellee,
against
PACKAGING INDUSTRIES, INC.,
Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFF-APPELLEE



WYATT, GERBER & SHOUP
Attorneys for Plaintiff-Appellee
230 Park Avenue
New York, New York 10017
679-7611

Of Counsel

ELIOT S. GERBER
GUY W. SHOUP

2



TABLE OF CONTENTS

	<u>Page</u>
ISSUES PRESENTED	1
ARGUMENT	3
Point I : THE CHALLENGE OF PATENT VALIDITY IS NOT BARRED BY RES JUDICATA	3
IA. The Prior Stipulation of Dismissal Is Not A Bar To A Later Challenge To Patent Validity. The Public Interest In Being Free of Invalid Monopolies Prevails	3
IB. Res Judicata Cannot Be Raised On Appeal — It Was Not An Issue Before The District Court..	11
IC. Res Judicata Does Not Apply — The Issues Are Not The Same	18
Point II: THE PARTIES' DISPUTE DOES NOT ARISE FROM THE LICENSE AGREEMENT AND IS NOT SUBJECT TO ARBITRATION	20
IIA. The License Agreement Terminated in 1969	20
IIB. A License Is Not A Promise Not To Infringe After Its Termination	21
IIC. This Action Is Not Arbitrable Because It Does Not Arise From The License Agreement — There Is No Promise By Diematic In The License Agreement To Not Infringe	22
IID. Arbitration Is Not Applicable Because The Relief Sought By Packaging And The Issues Involved Are Those Of An Ordinary Patent Infringement	24

TABLE OF CONTENTS (continued)

	<u>Page</u>
Point III: PATENT VALIDITY AND ANTI-TRUST QUESTIONS ARE EXCLUSIVELY WITHIN FEDERAL COURT JURISDICTION	28
IIIA. The District Court Has Exercised Its Discretion To Hear This Case — Such Exercise Was Not Error	28
IIIB. The Declaratory Judgment Action Is Superior To Arbitration Because It Can Afford Complete Relief — Arbitration Can Deal With Only One Issue	29
IIIC. The <u>Wycoff</u> Case Supports Diematic's Position Because Arbitration Is Not A State Court Proceeding	33
ADDENDUM B: Copy of Consent Decree From <u>Broadview Chemical Corp. v. Loctite Corp.</u> 474 F.2d 1391 (2nd Cir. 1973).....	40
ADDENDUM A: Decision on Pending Motions USM Corporation v. Standard Pressed Steel Co.	36

TABLE OF CITATIONS

<u>Cases</u>	<u>Page</u>
<u>Addressograph-Multigraph Corp. v. Cooper</u> 156 F.2d 483,485 (2nd Cir. 1946)	4,6,7,9
<u>American Lease Plans Inc. v. Houghton Construction Co.</u> 492 F.2d 34,37 (5th Cir. 1974)	14
<u>American Safety Equipment Corp. v. J.P. Maquire Co.</u> 391 F.2d 821,826 (2nd Cir. 1968)	31
<u>American Well Works Co. v. Layne & Bowler Co.</u> 241 U.S. 257, 60 L.Ed 987 (1916)	25
<u>Batson Yarn & F.M. Gr.Inc. v. Saurer-Allma GmbH-</u> <u>Allgauer M.</u> 311 F.Supp. 68,71 (D.C. S.C. 1970)	21
<u>Beckman Instruments v. Technical Developments Corp.</u> 433 F.2d 55 (7th Cir. 1970)	31
<u>Blonder-Tongue Laboratories, Inc. v.</u> <u>University of Illinois Foundation</u> 402 U.S. 313 (1971)....	5
<u>Bowdoin v. Malone</u> 287 F.2d 282,284 (5th Cir. 1971)	15
<u>Brose v. Sears, Roebuck & Co.</u> 455 F.2d 763,768 (5th Cir. 1972)	9
<u>Business Forms Finishing Service, Inc. v. Carson</u> 452 F.2d 70 (7th Cir. 1971)	5,6,7,8,9
<u>Broadview Chemical Corp. v. Loctite Corporation</u> 474 F.2d 1391 (2nd Cir. 1973)	6,7,8,9, 11,28,29,36
<u>Butterfield v. Oculus Contact Lens Corp.</u> 332 F.Supp. 750 (D.C. Ill. 1971)	9
<u>Crane Co. v. Aeroquip Corp.</u> 364 F.Supp. 547,549 (N.D. Ill. 1973)	9
<u>Container Products Corp. v. Stant</u> 143 F.2d 170,172 (7th Cir. 1944)	15
<u>Deepsouth v. Laitram</u> 406 U.S. 518, 530-531 (1972)	3

TABLE OF CITATIONS
(continued)

	<u>Page</u>
<u>DeSapio v. Kohlmeier</u> N.Y. Law Journal Dec. 3, 1974, pg. 1 (N.Y. Ct. Appeals 1974)	32
<u>Desert Palace Inc. v. Salisbury</u> 401 F.2d 320 (7th Cir. 1968)	14
<u>First National Bank of Cincinnati v. Pepper</u> 454 F.2d 626,636 (2nd Cir. 1972)	17
<u>Gardner v. Meyers</u> 491 F.2d 1184 (8th Cir. 1974)	15
<u>Graham v. John Deere Co.</u> 383 U.S. 1 (1965)	32
<u>Hartford-Empire Co. v. Obear-Nester Glass Co.</u> 95 F.2d 414 (8th Cir. 1938)	19
<u>Homewood Industries, Inc. v. Caldwell</u> 179 U.S.P.Q. 701 (D.C. Ill. 1973)	32
<u>General Tire & Rubber Co. v. Honorable R. Dorsey Watkins</u> 326 F.2d 926 (4th Cir. 1964)	24
<u>Hormel v. Helvering</u> 312 U.S. 552,556 (1941)	13
<u>Imperial Appliance Corp. v. Hamilton Manufacturing Corp.</u> 430 F.2d 185,187 (7th Cir. 1970)	25
<u>In re Cold Metal Process Co.</u> 9 F.Supp. 992 (D.C.Pa. 1935)..	32
<u>JFD Electronics Co. v. Channel Master</u> 229 F.Supp. 514 (S.D.N.Y. 1964)	24
<u>Jones v. Tower Production Co.</u> 120 F.2d 779,782 (10th Cir. 1941)	14
<u>Kraly v. National Distillers & Chemical Corporation</u> F.2d , 183 U.S.P.Q. 79 (7th Cir. 1974)	10
<u>Kyser Industrial Corp. v. Pet Incorporated</u> 459 F.2d 1010 (6th Cir. 1972)	24
<u>Kerotest Mfg. Co. v. C-O-Two Fire Equipment Co.</u> 342 U.S. 180, 96 L.Ed. 200 (1952)	30

TABLE OF CITATIONS
(continued)

	<u>Page</u>
<u>Lear v. Adkins</u> 395 U.S. 653 (1969)	4,6,10, 21,23,29 34
<u>Lawler v. National Screen Service</u> 349 U.S. 322 (1955)	18
<u>Leesona Corp. v. Cotwool Mfg. Corp., Judson Mills Div.</u> 204 F.Supp. 141 (D.C. SC 1962), aff'd 315 F.2d 538 (4th Cir. 1963)	32
<u>Lemelson v. Topper Corp.</u> 450 F.2d 845 (2nd Cir. 1971)....	32
<u>Luckett v. Delpark</u> 270 U.S. 496,510, 70 L.Ed. 703(1926)..	26
<u>Ludwig v. Marion Laboratories, Inc.</u> 465 F.2d 114,117 (8th Cir. 1972)	17,18
<u>Measurements Corp. v. Ferris Inst. Corp.</u> 159 F.2d 590,593 (3rd Cir. 1947)	21
<u>Massillon-Cleveland-Akron Sign Co. v. Golden State</u> <u>Advertising Co.</u> 444 F.2d 425 (9th Cir. 1971)	23
<u>Monroe Sander Corp. v. Livingston</u> 277 F.2d 6,10 (2nd Cir. 1967)	21
<u>National Equipment Rental, Ltd. v. Stanley</u> 283 F.2d 600,602 (2nd Cir. 1960)	16
<u>Overseas Motors, Inc. v. Import Motors Ltd. Inc.</u> 375 F.Supp. 499 (D. Mich. 1974)	18
<u>Patent & Licensing Corp. v. Olsen</u> 188 F.2d 522,525 (2nd Cir. 1951)	17
<u>Public Service Commission v. Wycoff Co.</u> 344 U.S. 237 (1952)	33,34 35
<u>Robin Products Co. v. Tomecek</u> 465 F.2d 1193 175 U.S.P.Q. 135 (6th Cir. 1972)	32
<u>Product Engineering & Manufacturing v. Barnes</u> 424 F.2d 42 (10th Cir. 1970)	34
<u>Poston v. Caraker</u> 378 F.2d 439 (5th Cir. 1967)	14

TABLE OF CITATIONS
(continued)

	<u>Page</u>
<u>Roberson v. United States</u> 382 F.2d 714,718 (9th Cir. 1967)	16
<u>Schwartz v. S.S. Nassau</u> 345 F.2d 465,466 (2nd Cir. 1965), cert. den. 382 U.S. 919 (1965)	16
<u>Schramm v. Oakes</u> 352 F.2d 143 (10th Cir. 1965)	12
<u>Schnitger v. Canoga Elec. Corp.</u> 462 F.2d 628 (9th Cir. 1972)	9
<u>Thiokol Chemical Corp. v. Burlington Industries</u> 448 F.2d 1328 (3rd Cir. 1971)	24
<u>Terkildsen v. Waters</u> 481 F.2d 201, 204-5 (2nd Cir. 1973)	15
<u>Travelers Indemnity Co. v. Abrogast</u> 45 F.R.D. 87,88 (W.D. Pa. 1968)	12
<u>U.S. v. Hayward-Robinson Co.</u> 430 F.2d 1077 (2nd Cir. 1970)	27
<u>U.S.M. Corp. v. Standard Pressed Steel Corp.</u> (N.D. Ill. October 24, 1974)	12
<u>Wagner v. Retail Credit Company</u> 338 F.2d 598,601 (7th Cir. 1964)	15
<u>White v. Chicago, Burlington & Quincy Railroad</u> 417 F.2d 941,946 (8th Cir. 1969)	12
<u>Wendell v. Holland America Line</u> 30 F.R.D. 162 (S.D.N.Y. 1961)	27
<u>Wyatt Earp Enterprises v. Sackman Inc.</u> 157 F.Supp. 621,626 (S.D.N.Y. 1959)	26
<u>Zip Mfg. Co. v. Pep Mfg. Co.</u> 44 F.2d 184,186 (D.C. Del. 1930)	32
<u>Authorities</u>	
BNA Patent Trademark and Copyright Journal No. 203,A-10..	10
3 Moore's Federal Practice 486-487	27
Moore's Federal Practice, 2nd Edition, Vol. 6, 57-61, §57.08	31
28 U.S.C. §1338(a)	24

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69

ISSUES PRESENTED

I. Is a challenge to patent validity in a declaratory judgment action barred by an alleged res judicata when:

(a) the alleged res judicata is based upon a stipulation of dismissal entered into prior to trial which did not admit patent infringement or validity, and was signed by a Clerk of the District Court;

(b) the license agreement between the parties also does not admit infringement;

(c) the defense of res judicata was not presented by motion or by an answer or by oral argument or by evidence to the District Court. The prior action documents are not in the record, the District Court has not passed on the issue and it is presented here on appeal for the first time; and

(d) the causes of action in the two cases are different — Diematic has changed its tray construction.

II. Was an arbitration proceeding correctly stayed when (a) the license agreement containing the arbitration clause had expired by its own express terms, and (b) there were no implied or express obligations in the license agreements which were continuing and therefore subject to arbitration.

III. Was an arbitration proceeding correctly stayed when the subjects involved in the dispute between the parties (patent validity and anti-trust) are not suitable matters for arbitration but are matters within the exclusive jurisdiction of the federal courts.

ARGUMENT

Point I

THE CHALLENGE OF PATENT VALIDITY IS NOT BARRED
BY RES JUDICATA

IA. The Prior Stipulation of Dismissal Is Not A Bar To A Later
Challenge To Patent Validity. The Public Interest In Being
Free of Invalid Monopolies Prevails

Packaging's first argument — raised for the first time in this Court — is that the District Court's stay of arbitration is barred by res judicata based upon a prior stipulation of dismissal. The stipulation was "So Ordered" by the Clerk of the Court (D-A Br., Add. 26a) and signed prior to any assignment of the prior action for trial. Thus, there was no adjudication of patent validity by the District Court even by consent. If a member of the public (it is the public interest that is paramount in the patent system, see, e.g., Deepsouth v. Laitram 406 U.S. 518, 530-531 [1972]) were to inspect the file of the prior (1965) action, he would not find admission of validity of the patent! If a member of the public were to inspect the file of the Packaging patent (as he has a right to do) he would also find no admission of validity (see 35 U.S.C. §290).

The private license agreement (A66a), signed about the same time, admitted patent validity (A70a) but did not admit past infringement (A 69a). A settlement and future license

is not an admission of past infringement.

Under Lear v. Adkins 395 U.S. 653 (1969) a patent licensee may challenge a patent's validity despite the licensee's prior admission of validity in the license. The only license in this case expired in 1969 (infra, p.18) and the admission of validity in that license (A70a), even if it did not terminate with the expiration of the license, was voided by Lear. For if Diematic, because of its admission of validity in a license agreement, would be barred from attacking patent validity — so would any patent licensee who signs a license to avoid the expense of a patent trial (regardless of the economic resources of the parties). Any patentee could undermine Lear and initiate the insulation of his patent from challenge by suing first and licensing later.

This Court has laid down the general rule governing consent decrees: any res judicata effect of a consent decree is circumscribed by the overriding policy consideration that the public interest is best served in obtaining a judicial determination of patent validity. Addressograph-Multigraph Corp. v. Cooper 156 F.2d 483, 485 (2nd Cir. 1946).

In Lear, the Supreme Court abandoned the doctrine of licensee estoppel because he was the only one sufficiently interested to challenge the licensed patent. In Lear the Court said:

Surely the equities of the licensor do not weigh very heavily when they are balanced against the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain. Licensees may often be the only individuals with enough economic incentive to challenge the patentability of an inventor's discovery. If they are muzzled, the public may continually be required to pay tribute to would-be monopolists without need or justification. 395 U.S. at 670

In Blonder-Tongue Laboratories, Inc. v.

University of Illinois Foundation 402 U.S. 313 (1971) the Court elaborated this point:

The far-reaching social and economic consequences of a patent, therefore, give the public a paramount interest in seeing that patent monopolies spring from backgrounds free from fraud or other inequitable conduct and that such monopolies are kept within their legitimate scope. [citing case] 402 U.S. at 343

The Court in Blonder-Tongue went on to point out an invalid patent is an effective barrier to competition by preventing new market entries. A priori, the burden falls most heavily on consumers (the public) who bear the high price of lack of competition and who lack sufficient economic interest (not to mention their lack of legal standing) to challenge an invalid patent.

Since Lear, courts have permitted even licensees who have expressly agreed not to contest the validity of a patent in a consent decree (not, as here, in a private license agreement) to challenge the patent. In Business Forms Finishing Service, Inc. v. Carson 452 F.2d 70 (7th Cir. 1971) the Court of Appeals followed Lear and Blonder-Tongue. Business Forms,

like this case, was a case where an admission of validity was entered into before Lear. Business Forms, unlike this case, was a case where there was an actual order of consent to validity entered by a District Court Judge after three days of trial. The Court of Appeals said:

In these circumstances, as the Second Circuit has held, a consent decree does not create an estoppel on the issue of validity. Addressograph Multigraph Corp. v. Cooper 156 F.2d 483 (2nd Cir. 1946). A contrary result could not be reconciled with 'the public interest in a judicial determination of the invalidity of a worthless patent.' Id. at 485. 452 F.2d at 75.

Packaging relies heavily on this Court's decision in Broadview Chemical Corp. v. Loctite Corporation 474 F.2d 1391 (2nd Cir. 1973) in arguing that the validity of the Packaging patent may not be challenged by Diematic in the District Court.

Broadview is based on an earlier Second Circuit holding, Addressograph-Multigraph Corp. v. Cooper 156 F.2d 483 (2nd Cir. 1946) where the Court stated:

We think on grounds of public policy we ought to rule that in a decree, at least in one entered by consent, either an adjudication of infringement, or a grant of some relief from which infringement may be inferred, is essential before any effect of res judicata can be given to it on the issue of validity. (156 F.2d 483) quoted in Broadview Chemical Corporation v. Loctite Corporation 474 F.2d 1391, 2d Cir. 1973.

This Court in Addressograph upheld the District Court's holding of patent invalidity in spite of the prior consent decree between

the same parties; the agreement in Addressograph terminated an earlier infringement action and the consent decree only adjudicated that the patent was valid and that the patentee had an exclusive right to it. In addition, the patentee waived the issuance of an injunction against the defendants. 156 F.2d at 483-484. This Court affirmed the District Court's decision that the agreement did not adjudicate the issue of infringement. The District Court in Addressograph had found (Addressograph-Multigraph Corp. v. Cooper 60 F.Supp. 697 [S.D.N.Y. 1945]) that: "The consent decree thereafter submitted by the plaintiff to the defendants and signed by them does not contain any allegation of infringement." As in Addressograph the stipulation of dismissal in this case makes no reference whatsoever to an adjudication of infringement.

Packaging argues that Broadview and not Business Forms is dispositive of this case. However, they may be reconciled, and both Broadview and Business Forms support Diematic's right to challenge patent validity.

Broadview was the culmination of lengthy litigation commencing in 1964. The first action was terminated in 1967 when the parties entered into a consent decree in which Broadview admitted patent validity and that Broadview infringed (474 F.2d at 1393); thus Broadview was an adjudication within the requirement of Addressograph that "an adjudication of infringement ... is essential before any effect of res judicata can be

given to it on the issue of validity." In Business Forms the Court of Appeals permitted a licensee's attack on validity despite a consent decree because the decree was not an adjudication of infringement. In this case, as in Business Forms and unlike Broadview, there has been no adjudication of infringement. The Broadview imbroglio was before this Court at least three times in reported decisions, 406 F.2d 538 (1969), cert. den. 394 U.S. 976 (1969); 417 F.2d 998 (1969) and 474 F.2d 1391 (1973) and before the District Court at least twice in reported decisions 311 F.Supp. 447 (D. Conn. 1970), 53 F.R.D. 353 (D. Conn. 1971). There were contempt motions based on the earlier consent decree, extensive factual adjudications as to damages, infringements (some thirty-two products were involved and there appear to have been specific findings on specific products). A full reading of all of the Broadview decisions indicates that the portion of the last Broadview decision so heavily relied upon by Packaging is largely a reflection of this Court's expressed desire to end once and for all nine years of litigation which had resulted in at least four District Court hearings and three appeals.

Here, Diematic has instituted the present action with the goal of ending, once and for all, all of the disputes between the parties.

Further, since Business Forms, a District Court has reiterated that a consent decree must be based on an

adjudication of infringement before licensee will be estopped from challenging the patent's validity. Crane Co. v. Aeroquip Corp. 364 F.Supp. 547,549 (N.D. Ill. 1973): " ... the undesirability of having the public pay royalties to one who does not have a valid patent outweighs the desirability of encouraging settlement of lawsuits." cf. Butterfield v. Oculus Contact Lens Corp. 332 F.Supp. 750 (D.C.Ill. 1971); Schnitger v. Canoga Elec. Corp. 462 F.2d 628 (9th Cir. 1972). There is no recitation in the Stipulation of Dismissal of the 1965 case of the requisite admission of infringement by Diematic that would be required under any reading of Broadview.

In addition, the terminated License Agreement in this case makes no mention of past infringement and the provision reciting the paid-up royalty is couched in language of "settlement" and "release", and says nothing about possible infringement (A69a). Thus, Business Forms controls, because there the consent decree (apart and aside from the fact that in this case there was a Stipulation of Dismissal and not a consent decree) made no admission of infringement. Cf. Brose v. Sears, Roebuck & Co. 455 F.2d 763,763 (5th Cir. 1972).

The requirement promulgated by this Court in Addressograph and followed by both this Court and the Seventh Circuit in Broadview and Business Forms, which open patents to actual adjudication by the most interested party, has been

satisfied, because here there was no adjudication of infringement.

Recently, a somewhat broader interpretation of Lear has been formulated (Packaging contends this interpretation should not be followed). In Kraly v. National Distillers & Chemical Corporation F.2d , 183 USPQ 79 (7th Cir. 1974) the court indicated that, even though the consent order did not contain an express admission of infringement within the requirement of Broadview, supra, any such consent decree was against public policy, relying upon the policies announced in Lear and Blonder-Tongue. The Court of Appeals said:

Even if we assume, however, that the consent decree embodied an adjudication of infringement, we do not believe that the Lear rationale would necessarily be inapplicable. To allow the parties to consent to an adjudication of infringement would simply result in the erection of another obstacle to tests of patent validity. We conclude that National Distillers, the licensee, is not estopped from challenging the validity of the patent, even though a prior consent decree incorporated an understanding not to challenge the validity of the patent. F.2d at (emphasis added)

Subsequent to Kraly, supra, a District Court in U.S.M. Corp. v. Standard Pressed Steel Corp. (N.D. Ill. October 24, 1974), Add. A (see also BNA Patent Trademark and Copyright Journal No. 203, A-10) struck down a consent decree because the decree was not the product of a litigated decision and was not signed by a judge familiar with the litigation. Here, the Stipulation of Dismissal made no admission of infringement and was signed by the clerk of the court,

an act indicating that perhaps no judge was familiar with the litigation. In any event, this Court does not have to follow Kraly, supra, to affirm, as we have pointed out, that Broadview and Business Forms are consistent and both would allow affirmance.

IB. Res Judicata Cannot Be Raised On Appeal —
It Was Not An Issue Before The District Court

Packaging seeks to argue res judicata — an issue not raised by its motion and not considered by the District Court.

There was not one word even hinting at that issue in the hundreds of pages of documents presented to the District Court.

Until the filing of its Brief, Packaging did not raise the issue of res judicata in this Court. It does not appear in its Civil Appeal Pre-Argument Statement, filed November 8, 1974 (either in "Brief Description of Nature of Case and Result Below" or in "Issues Proposed To Be Raised On Appeal"). It was not mentioned in the pre-trial argument conference before Nathaniel Fensterstock, Esq., on November 14, 1974; in the "Designation of Parts of Record To Be Included in Appellant's Appendix" counsel's letter accompanying such Designation said, inter alia, that "Enclosed is our appendix designation which I trust you will find contains every record item either of us may rely upon in our Appellate briefs."

And finally, in a letter dated December 11, 1974 concerning designation of the record, Packaging's counsel stated:

Lastly, we cannot honor your request for the inclusion of a document which appeared as an attachment to your interrogatories because this would violate both the Federal Rules for Appellate Procedure and the Local Rules of the Second Circuit. Neither your interrogatories nor attachments thereto were considered by the District Court in rendering the decision being appealed and they are therefore not properly a part of the Record on Appeal. (emphasis added)

It is the general rule that defenses, such as res judicata, not specifically raised in the trial court are waived and may not be presented on appeal. White v. Chicago, Burlington & Quincy Railroad 417 F.2d 941, 946 (8th Cir. 1969); see Wagner v. Retail Credit Co. 338 F.2d 598, 601 (7th Cir. 1964).

The affirmative defense of res judicata alleged by Packaging (the appellee) could have been affirmatively pleaded or raised on motion, Travelers Indemnity Co. v. Abrogast 45 F.R.D. 87, 88 (W.D. Pa. 1968). Where res judicata was raised neither by motion nor answer, which is the situation present here, the Court of Appeals in Schramm v. Oakes 352 F.2d 143 (10th Cir. 1965) held that res judicata must be raised at the trial level and may not be raised for the first time on appeal. The court stated:

Appellee, Todkill Lincoln-Mercury, Inc., has filed a petition for rehearing and raised on appeal the affirmative defense of res judicata or collateral estoppel. The same issue was raised by its separate brief filed before argument and the issue was not given consideration in the opinion because we deemed it to be improperly raised. The defenses of res judicata and collateral estoppel are affirmative defenses, must be raised as such on the trial level and cannot be raised for the first time upon appeal. We do not express any views as to the merits of these defenses as applied to this case because that is the function, in the first instance, of the trial court after such defenses have been properly raised by adequate pleadings.
(352 F.2d at 150)

When new issues are raised for the first time on appeal, there is a deleterious effect on judicial economy because such questions are more appropriately resolved in the trial court and the introduction of a new defense places the adversary at an unnecessary disadvantage with no fair opportunity to present sufficient proof to counter a new defense.

In Hormel v. Helvering 312 U.S. 552, 556 (1941) the Supreme Court stated:

Ordinarily an appellate court does not give consideration to issues not raised below. For our procedural scheme contemplates that parties shall come to issue in the trial forum vested with authority to determine questions of fact. This is essential in order that the parties may have the opportunity to offer all the evidence they believe relevant to the issues which the trial tribunal is alone competent to decide; it is equally essential in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence.* *

When appellate courts face the situation where new defenses are raised on appeal, they are rejected virtually immediately. See, e.g., Bowdoin v. Malone 287 F.2d 282, 283

(5th Cir. 1961) where the court rejected without discussion a new defense (statute of limitations) raised in the appellate brief because it was not before the lower court. A similar situation was discussed in Desert Palace Inc. v. Salisbury 401 F.2d 320 (7th Cir. 1968) where the court stated at 324:

We need cite only a few of the many cases which have held that a litigant cannot present to this court as a ground for reversal an issue which was not presented to the trial court and which it, therefore, had no opportunity to decide. As was said in Occidental Petroleum Corp. v. Walker 10 Cir., 298 F.2d 1,6:

It is a well-recognized rule of frequent application that a party litigant may not sit quiet at the time action is taken in the trial court and then complain on appeal. He is required to indicate in some appropriate manner his objection or dissent. Otherwise, no question is preserved for review on appeal.

This rule that new matter may not be raised on appeal does not prejudice the party who attempts to introduce the new evidence because they had their opportunity to present the material and it is reasonable to assume that they would have done so. This was emphasized in Poston v. Caraker 378 F.2d 439 (5th Cir. 1967) where the court held as follows at 442-43:

It is only reasonable to assume that when confronted with the motion to dismiss appellants met it with the most favorable language they could find in the trust instrument. In any event, it is too fundamental to require citations that they must stand or fall here on the issues as presented below. They cannot now invoke what might have been.

Accord: American Lease Plans Inc. v. Houghton Construction Co. 492 F.2d 34,37 (5th Cir. 1974); Jones v. Tower Production Co. 120 F.2d 779,782 (10th Cir. 1941); Gardner v. Meyers

491 F.2d 1184 (8th Cir. 1974); Wagner v. Retail Credit Company

338 F.2d 598,601 (7th Cir. 1964); Bowdoin v. Malone

287 F.2d 282,284 (5th Cir. 1971).

The primary purpose for the rule is that when dealing with defenses, particularly affirmative defenses such as res judicata, it is the defendant's burden to prove the defense. In Container Patents Corp. v. Stant 143 F.2d 170,172 (7th Cir. 1944), cert. denied 323 U.S. 734 (1944) the court stated:

As to this defense, it is sufficient to say that it was not presented to the court below and it cannot be presented here for the first time. New York Life Ins. Co. v. Calhoun, 8 Cir. 114 F.2d 526,543; Ramming Real Estate Co. v. United States, 8 Cir. 122 F.2d 892; Hutchinson v. Fidelity Investment Association, 4 Cir., 106 F.2d 431,426, 133 A.L.R. 1961; Towle v. Pullen, 7 Cir. 238 F.107,111. The only places in the record where the point is mentioned are the opening statement of counsel, the objections to the master's report (which could not have considered the issue at all), and the statement of point to be urged on appeal. None of these references seems to us to have adequately presented the issue to the trial court. But even assuming that this question had been presented to the trial court, the absence of any findings by the court thereon is equivalent to a finding against the defendants, whose burden it was to sustain this proposition.

When a party raises new issues on appeal, it deprives the court of the informed opinion of a district judge who has considered the issue and formulated an opinion to inform the appellate court. In Terkildsen v. Waters 481 F.2d 201, 204-5 (2nd Cir. 1973) this court stated:

Under these circumstances, we see no reason to depart from the general rule of practice which forecloses appellate consideration of issues not raised below. See, e.g., Hormel v. Helvering, 312 U.S. 552, 556, 61 S.Ct. 719, 85 L.Ed. 1037 (1941). Adherence to the rule is particularly apt where, as here, factual questions may have been implicated as to which the judge made no findings because the issue was not directly raised and equally, where considerations underlying a subtle legal issue could have been exposed and distilled by the able district judge so as to facilitate more informed consideration by this court. ... Accordingly, we decline to consider an issue so belatedly raised. (481 F.2d at 204)

See National Equipment Rental, Ltd. v. Stanley 283 F.2d 600, 602 (2nd Cir. 1960) where the Second Circuit stated, at 603:

It is abundantly clear that court and counsel tried the case below on the assumption that such was the only question. The issues cannot now be changed on appeal.

See also Roberson v. United States 382 F.2d 714, 718 (9th Cir. 1967): ("An appellant may not urge as a ground for reversal a theory which he did not present when the case was before the trial court"); Schwartz v. S.S. Nassau 345 F.2d 465, 466 (2nd Cir. 1965) cert. den. 382 U.S. 919 (1965) ("This second claim [the statute of limitations has not run] was not raised in the district court and cannot be raised for the first time here".).

This case does not present an "exceptional circumstance" where an appellate court may permit argument of new issues on appeal. That exception exists only to present grave injustice. In this case Packaging may, after this court acts, plead res judicata in its answer (not yet filed) and be

heard on that issue at trial. The "exceptional circumstances" exception is narrowly construed and circumscribed because it severely contradicts the fundamental purposes of the courts. Judge Learned Hand emphasized this purpose:

To the defendant's argument that the plaintiffs had brought and tried the action upon the theory that their land had been injured by the defendant's negligence, the plaintiffs replied that, when a judgment has resulted in grave injustice an appellate court may intervene, though the question was not raised below. There are indeed occasions when a court will do so. *United States v. Trypuc*, 2 Cir. 136 F.2d 900; *United States v. Haug*, 2 Cir. 150 F.2d 911, 915; *Dowell, Inc. v. Jowers*, 5 Cir., 166 F.2d 214, 221, 2 A.L.R. 2d, 442. However, it is obvious that such a power must be sparingly exercised, since it is an exception to the fundamental purpose for which courts are maintained—to decide disputes, as the parties present them and not to amend their claims after they have been determined against them. As we said in *Alaska Pacific Salmon Co. v. Reynolds Metals Co.*, 21 Cir. 163 F.2d 643, 659, it is only an 'egregious kind of error' (that) 'we may consider of our own motion.' *Scott v. Central Commercial Co.* 272 F.2d 781, 782 (2nd Cir. 1959) cert. den. 363 U.S. 806, 4 L.Ed. 2d 1149 (1960).

In *First National Bank of Cincinnati v. Pepper* 454 F.2d 626, 636 (2nd Cir. 1972) this Court indicated that only 'defective jurisdictional allegations pursuant to 28 U.S.C. §1653: may be considered initially on appeal because the Appeal Court "cannot consider a 'new issue, not raised by the pleadings in the District Court or considered by it', whether raised by motion to amend a complaint or otherwise". See also *Patent & Licensing Corp. v. Olsen* 188 F.2d 522, 525 (2nd Cir. 1951); *Ludwig v. Marion*

Laboratories, Inc. 465 F.2d 114,117 (8th Cir. 1972) which at 117 stated: "We cannot now re-try this lawsuit upon a theory not presented below and we will not do so".

IC. Res Judicata Does Not Apply — The Issues Are Not The Same

Packaging asserts, in a broad-brush chart (D-A Br., p.9) that the claims of Diematic in the 1968 and 1974 action are the same. These assertions are only arguments of Packaging and lack any basis in the record by way of pleadings, discovery, testimony, exhibits or, needless to say, any findings of the District Court. Diematic recognizes this Court to be a Court of Appeal — one the last resort and not first resort.

Without limiting itself in any way, and without having been given the opportunity to advance proofs on the issue, here are just a few differences between the 1974 claims of Diematic and the 1965 claims of Diematic — putting to one side Diematic's fundamental arguments that (1) the stipulation of dismissal is not a bar to a challenge to Packaging's patent and (2) the licensing agreement, and with it the arbitration clause, expired long ago:

1. Diematic's present antitrust allegations: acts of monopolization since 1969 are certainly new, and provable, see Lawler v. National Screen Service 349 U.S. 322 (1955). Cf. by analogy Overseas Motors, Inc. v. Import Motors Ltd.Inc. 375 F.Supp. 499 (D. Mich. 1974). Certainly the operative facts

underlying the violation (e.g., market share), the impact and the amount of damage have changed (A17a-18a, Par. 41-45).

2. Diematic now alleges it has the unlimited right to sell products under the Covenant Not To Sue, a document separate and apart from the expired license agreement (A 11a, Par. 21).

3. Diematic now alleges laches on the part of Packaging (A120, Par. 23).

4. Diematic now alleges Packaging is estopped from asserting its patent (A 12a, Par. 23).

5. In this case the issue of infringement is markedly different because Diematic's structures, which it claims to be free of Packaging's patents, are substantially different from those charged with infringement in the earlier action, Hartford-Empire Co. v. Obear-Nester Glass Co. 95 F.2d 414 (8th Cir. 1938). Additionally, the new trays are made under Diematic's own United States patent which issued since the arbitration agreement expired and, naturally, since the stipulation of dismissal was signed.

Point II

THE PARTIES' DISPUTE DOES NOT ARISE FROM THE LICENSE AGREEMENT
AND IS NOT SUBJECT TO ARBITRATION

IIA. The License Agreement Terminated in 1969

Diematic argued to the District Court that the License Agreement with Packaging of June 6, 1968 (A66a - 72a) expressly terminated in 1969.

The District Court's opinion (A111a - A 112a) views the License Agreement to have survived because the Packaging patent had a life longer than the nine-month life of the License Agreement (A112a).

But:

(1) the License Grant (A66a - A67a) is for a period of "nine(9) months" (recited twice) and "shall terminate at the end of said nine-month period"; and

(2) the "Records and Accounting Records" clause of the license agreement indicates that royalties will be payable for the nine-month period at the end of such nine-month period (A67a - 68a).

A fair reading of the entire License Agreement shows that, first, the License Agreement is contemplated to last for a period of nine months and, second, no period other than nine months is indicated as the life of the agreement (e.g.,

the agreement not to contest the validity of the patent does not state that it is for the life of the patent).

Finally, even if the no-contest clause survived in the License Agreement (not a Consent Judgment) it was voided by the 1969 Lear case. So, in either event, by its express terms or because of the 1969 Lear case, the License Agreement terminated in 1969 and there was nothing left to arbitrate.

IIB. A License Is Not A Promise Not To Infringe After Its Termination

After the nine-month period of the License Agreement, Diematic could "act in respect of the patent, with the rights and responsibilities of strangers to the licensor", Measurements Corp. v. Ferris Inst. Corp. 159 F.2d 590,593 (3rd Cir. 1947). There was no express promise in the License Agreement to not infringe after termination. Even if there had been, it would have been voidable under Lear, supra. In its argument to the District Court Packaging cited cases*in which arbitration occurred after termination, but they were all cases in which the dispute arose during the contract period. In this case the dispute arose five years after the 1969 termination.

* Batson Yarn & F.M. Gr. Inc. v. Saurer-Allma GmbH-Allgauer M. 311 F.Supp. 68,71 (D.C. S.C. 1970) - breach occurred Dec. 31, 1967, contract terminable June 1, 1968; Monroe Sander Corp. v. Livingston 277 F.2d 6,10 (2nd Cir. 1967) " ... during the term of the collective bargaining agreement".

IIC. This Action Is Not Arbitrable Because It Does Not Arise From The License Agreement — There Is No Promise By Diematic In The License Agreement To Not Infringe

The arbitration clause of the License Agreement states:

Questions of interpretation, enforcement and all disputes between the parties arising from this agreement shall be submitted to arbitration ...
(emphasis added)

The license agreement expired on March 6, 1969 (A66a - A88a). Diematic argues that its continued production of different products is not concerned with the terminated license agreement — Packaging apparently agrees because it contends that such production "is infringing upon the Patent" (A53a).

Packaging's only argument that this action is one "arising from" the License Agreement and is therefore subject to arbitration is that the agreement contains an implied obligation to not infringe after the nine-month period. That argument is premised on an incorrect assumption: that there is an implied obligation by a patent licensee to not infringe after the license terminates.

Such an obligation to not infringe is nowhere expressed in the License Agreement, so it must be implied. The

District Court said (All4a) that an obligation not to infringe in effect flowed from the obligation not to contest patent validity, citing Business Forms, supra. But Diematic's obligation not to contest validity was voided by the 1969 Lear case. The courts, in interpreting Lear, have held that a bare promise not to contest validity, without a continuing license, is void, see Massillon-Cleveland-Akron Sign Co. v. Golden State Advertising Co. 444 F.2d 425 (9th Cir. 1971). And if one who has promised not to contest patent validity may now do so, by virtue of Lear, then any implied obligation to not infringe, i.e., to not manufacture, is equally void. This follows from Lear and from the decisions following Lear because only a producing manufacturer, i.e., one who might infringe, is likely to have the economic incentive to challenge validity.

It is clear both as a matter of fact and of law that the present infringement dispute is not a dispute "arising from" the License Agreement because there is no agreement by Diematic to not infringe.

Packaging has now newly accused Diematic of infringement; Diematic denies infringement. That accusation and that dispute have nothing to do with the nine-month License Agreement. It is outside of the license agreement and consequently does not arise under the agreement and is not covered by its arbitration clause. The parties' present dispute is therefore not subject to arbitration.

IID. Arbitration Is Not Applicable Because The Relief Sought
By Packaging And The Issues Involved Are Those Of An
Ordinary Patent Infringement

Packaging's statement of "relief sought" in the arbitration (A54a) asks for an accounting for the use of its patent and an injunction against further sales by Diematic.

Such relief, as was recognized by the District Court (A113a) is not, at heart, the enforcement of a contractual obligation. Rather, Packaging seeks the same relief in arbitration which may be granted by a federal court in a patent infringement action (Diematic, of course, seeks new relief and broader relief). As such, Packaging's cause of action is a federal cause for patent infringement, and not a state cause for contract breach and this case is "a patent case" within the meaning of 28 U.S.C. §1338(a):

The District Courts shall have original jurisdiction of any civil action arising under any Act of Congress relating to patents ... Such jurisdiction shall be exclusive of the courts of the states in patent ... cases. (emphasis added)

See, e.g., Kyser Industrial Corp. v. Pet Incorporated
459 F.2d 1010 (6th Cir. 1972); JFD Electronics v. Channel Master
229 F.Supp. 514 (S.D.N.Y. 1964); Thiokol Chemical Corp. v.
Burlington Industries 448 F.2d 1328 (3rd Cir. 1971);
General Tire & Rubber Co. v. Honorable R. Dorsey Watkins
326 F.2d 926 (4th Cir. 1964).

The District Court concluded (All3a) "that Packaging's claim rests both upon its patent and upon the agreement" and correctly pointed out that part of Packaging's claim which was for patent infringement "falls within the exclusive jurisdiction of the federal courts under 28 U.S.C. §1338(a) and may not be decided by the arbitrators or the state courts", and, again correctly, finally concluded that the "questions of patent validity and infringement" were "inappropriate for determination in arbitration proceedings" (All5a).

But, in addition to being "inappropriate", there is a separate ground for hearing the entire dispute in the Federal Courts and staying the arbitration — because the "essential question" or the "issue involved" is one of patent validity and infringement and not one of contract interpretation. The main cause of action or "essential question" is created by the patent laws. American Well Works Co. v. Layne & Bowler Co. 241 U.S.257, 60 L.Ed.987 (1916). In Imperial Appliance Corp. v. Hamilton Manufacturing Corp. 430 F.2d 185,187 (7th Cir. 1970) the Court of Appeals said:

Thus the determination of whether a device is an improvement is a question of law resting upon matters such as the validity of the patent on the alleged improvement and the extent of its dependence upon existing patents. 1 A.W. Deller, Walker on Patents, §19 at 130 (2nd Ed. 1964). To require this question to be decided by state courts when further questions of contract interpretation are not involved would defeat the policies of uniformity and expertise which prompted Congress to grant exclusive patent jurisdiction to the federal courts.

This is not a case where the patentee sues for royalties or specific performance of a license — because Diematic owes no royalties and did not promise not to infringe after the nine-month license period. See, e.g., Luckett v. Delpark 270 U.S.496,510, 70 L.Ed. 703 (1926).

In a case much in point, Chief Judge Edelstein, in Wyatt Earp Enterprises v. Sackman Inc. 157 F.Supp. 621,626 (S.D.N.Y. 1958) stayed arbitration of a trademark dispute after termination of a trademark license:

The written agreement between the parties provides for the arbitration of any dispute or disagreement between the parties 'arising out of or relating to' the licensing contract. But the controversy between the parties, certainly the claim of the plaintiff, is one involving the issue of unfair competition. The action sounds not in contract but in tort, and the issue is not defined by the question of the rights of the parties under the agreement. If the dispute were confined to issues of whether or not the contract was violated, it would be referable to arbitration. But 'the issue involved', see International Union, United Automobile Aircraft v. Benton Harbor Maleable Industries, 6 Cir., 242 F.2d 536,539,542, is much broader in scope, requiring a consideration of facts and factors beyond the contract. Even if any existing subordinate contract issues were involved by arbitration, 'the issue involved' would remain. Indeed, in the absence of a license agreement and of defendant's operation under it, the broad issue would remain. No arbitration decision interpreting the contract could determine the controversy at bar. To delay the suit for injunctive relief and require arbitration would merely add to the 'costliness and delays of litigation' it was the purpose of the Arbitration Act to eliminate. 68 Cong., 1st Sess., House of Rep. Report No. 96. For the controversy between the parties would still have to be decided by this court.

Diematic's goal is on all fours with Chief Judge Edelstein's decisions — to settle all disputes between the parties in one action, which can only be the action in the federal court, 3 Moore's Federal Practice 486-487; U.S. v. Hayward-Robinson Co. 430 F.2d 1077 (2d Cir. 1970); Wendell v. Holland America Line 30 F.R.D. 162 (S.D.N.Y. 1961).

Point III

PATENT VALIDITY AND ANTI-TRUST QUESTIONS ARE EXCLUSIVELY
WITHIN FEDERAL COURT JURISDICTION

IIIA. The District Court Has Exercised Its Discretion To Hear
This Case — Such Exercise Was Not Error

The Declaratory Judgment Act 28 U.S.C.A. §2201

states, in pertinent part:

In case of actual controversy within its jurisdiction ... any court of the United States upon the filing of an appropriate pleading, may declare the rights and other legal relationships of any interested party seeking such declaration, whether or not further relief is or could be sought.
(emphasis added)

Count I of the Complaint is a declaratory judgment action for patent invalidity and non-infringement (A4a). Packaging never disputed that: (1) the case presents an actual controversy, and (ii) it is within the jurisdiction of the Federal Court, and (iii) an appropriate pleading was filed. Packaging argues that the District Court has discretion to hear or not to hear the case. But it has exercised its discretion to hear the case.

The question presented to this Court is whether its exercise was an abuse of discretion.

This Court, in reviewing the trial court's decision, has used the standard of asking if the trial court committed "error", see Broadview Chemical Corp. v. Loctite Corp. 417 F.2d 998 (2nd Cir. 1969), cert. den. 397 U.S. 1064 (1970).

In the Broadview case this Court stated:

... 'The two principal criteria guiding the policy in favor of rendering declaratory judgments are (1) when the judgment will serve a useful purpose in clarifying and settling the legal relations in issue, and (2) when it will terminate and afford relief from the uncertainty, insecurity, and controversy giving rise to the proceeding'. Borchard, supra, at 299. It follows as a general corollary to this rule that if either of these objectives can be achieved the action should be entertained and the failure to do so is error.

The District Court's decision to hear the declaratory judgment count was clearly not in error because, to paraphrase the Broadview quotation, its judgment would clarify and settle the legal relations in issue and it will terminate and afford relief from the uncertainty, insecurity and controversy giving rise to the proceeding.

IIIB. The Declaratory Judgment Action Is Superior To Arbitration Because It Can Afford Complete Relief —
Arbitration Can Deal With Only One Issue

Packaging argues that judicial economy dictates that this case should be sent to arbitration. But that argument is based upon both a myth and a chimera.

The myth is that the courts are burdened by multiple attacks on patent validity by licensees. The fact is that in about the five-year period since the 1969 Lear decision (reported cases in 164 through 183 United States Patents Quarterly) this Court has not heard a single such appeal. In that period there have been 20 appeals reported in which patent validity was

an issue (an average of 4 a year) — but not one of them was an attack on validity by a patent licensee.*

The chimera is that the arbitrators can decide the entire case and thereby save time and money. In fact, the arbitrators can, if allowed to proceed, arguably decide only one issue in the case (infringement) — and their efforts will only prolong the litigation and make it more expensive because the District Court will still have to decide the patent validity, anti-trust, laches and estoppel issues.

In a case involving the application of the Declaratory Judgment Act to a patent dispute, Justice Frankfurter, in Kerotest Mfg. Co. v. C-O-Two Fire Equipment Co. 342 U.S. 180, 96 L.Ed. 200 (1952) stated, at 183:

... Wise judicial administration, giving regard to conservation of judicial resources and comprehensive disposition of litigation, does not counsel rigid mechanical solution of such problems. The factors relevant to wise administration here are equitable in nature. Necessarily, an ample degree of discretion, appropriate for disciplined and experienced judge, must be left to the lower courts.

Here, the District Court has determined that the case should proceed, on all issues, as a federal court action and not be broken up into sequential arbitration and federal (and perhaps state) court actions.

* The District Court patent decisions in this Circuit (U.S.P.Q. Vols. 180-183) indicated none of them decided, on the merits, a challenge to validity by a licensee.

It is widely accepted that, as between two actions, the one having the relative advantage should prevail, see Moore's Federal Practice (2nd Ed. 1974) Vol. 6, 57-61, §57.08. Of course, the private arbitration proceeding is not an "action" in the sense of an alternative federal or state court proceeding. But, even ignoring that distinction, it is clear that in this case the declaratory judgment action is superior to an arbitration proceeding for the following reasons and should prevail:

i. The declaratory judgment action can resolve the anti-trust portion of the complaint (A15a - Count III) — but an anti-trust complaint is not subject to arbitration,

American Safety Equip. Corp. v. J.P. Maquire & Co.

391 F.2d 821,826 (2nd Cir. 1968).

ii. The declaratory judgment action can resolve the issue of patent validity, which is an essential issue in this case. The arbitrators should not be able to decide the patent validity issue as it is a matter of exclusive jurisdiction of the federal courts. As stated in Beckman Instruments v.

Technical Developments Corp. 433 F.2d 55 (7th Cir. 1970) at 62:

It is evident that the parties did not expressly provide for arbitration of patent validity questions. Moreover, we are in accord with the District Court's view that such questions are inappropriate for arbitration proceedings and should be decided by a court of law, given the great public interest in challenging invalid patents.

In this case, also, the parties did not expressly provide for arbitration.

Packaging has cited no case, and we have found none, where arbitration of patent validity was permitted or enforced. The courts which have considered the question have held that patent validity is not an appropriate subject for arbitration, see Leesona Corp. v. Cotwool Mfg. Corp., Judson Mills Div. 204 F.Supp. 141 (D.C. SC 1962), aff'd 315 F.2d 538 (4th Cir. 1963); Zip Mfg. Co. v. Pep Mfg. Co. 44 F.2d 184, 186 (D.C. Del. 1930); In re Cold Metal Process Co. 9 F.Supp. 992 (D.C. Pa. 1935); Homewood Industries, Inc. v. Caldwell 179 U.S.P.Q. 701 (D.C. Ill. 1973); and Robin Products Co. v. Tomecek 465 F.2d 1193, 175 U.S.P.Q. 135 (6th Cir. 1972).

The effect of the reference of patent validity challenges to arbitration is to prevent an open and effective hearing, since arbitration is secret and prevents effective pre-hearing discovery. DeSapio v. Kohlmeier, N.Y. Law Journal Dec. 3, 1974, pg. 1 (N.Y. Ct. Appeals 1974). It may be expected that the arbitrators would be patent attorneys, many of whom are ex-Patent Office Examiners, and businessmen. They are not likely to give patents the rigorous scrutiny mandated by the Supreme Court, Graham v. John Deere Co. 383 U.S. 1 (1965) and by this Court, Lemelson v. Topper Corp. 450 F.2d 845 (2nd Cir. 1971).

iii. The arbitrators could, we suppose, decide the patent infringement issue in the first instance; but then a court would have to determine if the arbitrators exceeded their authority. We maintain that the arbitrators would have exceeded authority, under the license agreement, to decide any existing issue between the parties, including infringement — because the

underlying license agreement terminated in 1969.

iv. The District Court, if allowed to proceed, can decide all the existing issues between the parties, i.e., patent validity, patent infringement, anti-trust and enforceability issues. But, in contrast, if the District Court action is stayed or dismissed and the stay of arbitration lifted, the arbitrators might proceed only with the issue of infringement. The case, to enforce the arbitration award as to infringement, would have to be again filed and start anew — because important issues would remain unresolved. The arbitrators cannot resolve the dispute between the parties; but the District Court can resolve all existing issues.

IIIC. The Wycoff Case Supports Diematic's Position Because Arbitration Is Not A State Court Proceeding

Packaging, in its brief in the District Court, relied primarily on the case of Public Service Commission v. Wycoff Co. 344 U.S. 237 (1952) in support of its motion to dismiss. The Wycoff case is here not applicable because:

1. In Wycoff the State Court could decide the entire controversy between the parties because the State Court had subject matter jurisdiction (at 252).

However, in this case the arbitrators do not have subject matter jurisdiction over Diematic's anti-trust and patent

invalidity and patent non-enforceability claims, and so cannot resolve the entire dispute between the parties. Indeed, if the arbitrators have any jurisdiction—and we do not think they do—they may be able to resolve the single issue of infringement.

2. In Wycoff the cause of action did not involve a present federal question. A state court can decide a federal question, such as patent validity, ancillary to its decision on a state cause of action, such as breach of a patent license agreement, see Lear v. Adkins, supra, and Product Engineering & Manufacturing v. Barnes 424 F.2d 42 (10th Cir. 1970). However, in this case the primary questions are federal questions, namely, patent validity, patent enforceability, and anti-trust.

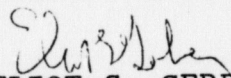
3. The Wycoff case dealt with the limits of the "permissible discretionary use of the Federal Declaratory Judgment Act" in view that "this dispute has not matured to a point where we can see what, if any, concrete controversy will develop" (at 245). In this case it is clear that there is a present and actual controversy between the parties — such is not contested by Packaging.

4. We understand that Packaging relies upon that part of the Wycoff opinion which is obiter dicta and which points to the factor of "a proper federal-state relationship" (at 247) and specifically seeks to avoid conflict between a federal court and a state agency (Utah Public Service Commission). But in this

case no such federal-state problem is presented because the arbitrators are private and the state is not involved.

Packaging's entire argument is merely an analogy that arbitrators are like judges and therefore the federal courts should not stay an arbitration. But the analogy fails because comity in Wycoff is premised on (i) a federal-state relationship, and (ii) settlement of the entire dispute. There is no federal-state question in this case and the arbitrators cannot settle the entire dispute.

Respectfully submitted,


ELIOT S. GERBER
WYATT, GERBER & SHOUP
230 Park Avenue
New York, New York 10017

Attorneys for Plaintiff-Appellee

February 14, 1975

ADDENDUM A

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

USCA - 7th Circuit

FILED

NO. 74 C 1514

USM CORPORATION,

Plaintiff,
Counter-Defendant,

v.

STANDARD PRESSED STEEL CO.,

Defendant,
Counter-Plaintiff.

THOMAS F. STRUBBE
CLERK

NO. 74 C 1514

DECISION ON PENDING MOTIONS

The complaint in this case is filed by a licensee of defendant's Villo patent who now wishes to contest the validity of that patent. The license was granted on April 12, 1971 as part of a settlement of an infringement action brought in this court by the defendant against the plaintiff. That suit was dismissed with prejudice and included a recitation that the patent was valid and infringed by the present plaintiff. Plaintiff has been paying royalties on the license until after the present suit was filed.

The complaint seeks a modification of the prior decree, a declaration of invalidity and non-infringent, and damages for restraint of trade. The case now comes on to be heard on plaintiff's motion for a preliminary injunction to prevent defendant from taking any action based on plaintiff's failure to pay royalties on the license, and on defendant's motion for partial summary judgment on the issue of the patent's validity on the ground of res judicata of the prior consent decree. We find and conclude that both motions should be denied.

The motion for a preliminary injunction, being the first one filed, would permit plaintiff to be absolved pendente lite from liability on a contract and consent decree which have been in effect since 1971. We cannot say that plaintiff has that certitude of ultimate success which would justify setting aside an arm's length agreement while it is paying no royalties. Plaintiff has an adequate remedy at law if it succeeds in this litigation, and its unilateral change of the status quo by terminating royalty payments should not be formalized even provisionally by a court order. If plaintiff chooses to litigate the validity of a prior agreement which was incorporated into a consent decree, it will have to do so without the shelter of a preliminary injunction.

The defense of res judicata has been pretty well emasculated by recent court decisions which, we believe, render summary judgment in this case unavailable as a matter of law. The most recent case is Kraly v. National Distillers and Chemical Corp., ____ F.2d ____, (7th Cir. #73-1589, -1590, July 25, 1974), decided after the defendant's motion was filed. That decision affirmed a ruling which permitted a licensee to contest the validity of a patent, despite an existing consent decree reciting that the defendant would not contest the validity of the patent, that all claims for infringement had been fully settled, and dismissing the complaint with prejudice. The licensee was not only relieved of future royalty payments but also succeeded in invalidating several claims of the patent.

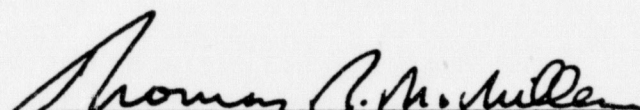
Despite defendant's valiant efforts to distinguish the Kraly decision after it came down, we cannot see any really substantive distinction. The consent decree in the case at bar, although facially upholding the merits of the patent, was not the product of a litigated decision. In fact, it was signed by a judge who apparently was not regularly assigned to the case and who had not participated in any of the pre-trial matters, so far as the record shows. Although we would not lightly set aside the findings contained in a

signed decree, the parties in the case at bar agree that it was merely a matter of formalizing a license agreement. Such a decree would have no effect on the rights of third parties under Blonder-Tongue Laboratories v. University of Illinois Foundation, 402 U.S. 313 (1971) and would be contrary to the policy of unfettered contesting of patents announced in Lear Inc. v. Adkins, 395 U.S. 653 (1969).

Aside from the legal defense of res judicata, defendant's motion for partial summary judgment makes no real attempt to overcome genuine issues of material fact. Once the pre-existing decree is overcome, all counts of the complaint are open for litigation.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that the Motion of plaintiff for a preliminary injunction is denied, and the Motion of defendant for partial summary judgment is denied. This case will be called for a report on status on Tuesday, November 5, 1974 at 10:00 a.m.

ENTER:


JUDGE, U. S. DISTRICT COURT

DATED: October 24, 1974

ADDENDUM B

Copy of Consent Decree From
Broadview Chemical Corp. v. Loctite Corp. 474 F.2d 1391 (2nd Cir.1973)

[Caption omitted]

Consent Decree

This cause coming on to be heard, upon the pleadings and proceedings heretofore had herein, and it being represented to the Court that the parties hereto have settled their differences with respect to the matters in dispute, and upon the sub-joined consent of the parties acting through their attorneys, it is hereby:

ORDERED, ADJUDGED AND DECREED:

1) That this Court has jurisdiction of the parties and of the subject matter hereof;

2) That United States Letters Patent Nos. 2,895,950 issued July 21, 1959; 3,043,820 issued July 10, 1962; and 3,046,262 issued July 24, 1962, were duly and legally issued and are good and valid at law, and Defendant is the sole owner thereof.

3) That Plaintiff has infringed said United States Letters Patent Nos. 2,895,950; 3,043,820 and 3,046,262 by the manufacture and sale of products made under formulations covered by said Letters Patent;

4) That Plaintiff, its officers, directors, employees, agents, successors and assigns be and they are hereby enjoined from infringing said United States Letters Patent Nos. 2,895,950; 3,043,820 and 3,046,262;

5) That Plaintiff's second cause of action and Defendant's second counterclaim be and the same are hereby dismissed with prejudice;

6) That Plaintiff having made a monetary payment to the Defendant, no damages shall be awarded as a result of this action; and

7) That each party pay its own costs and attorneys fees in this action.

M. JOSEPH BLUMENFELD
United States District Judge

Date: Feb. 14, 1967

WE HEREBY CONSENT TO THE ENTRY OF THE ABOVE DECREE:

BROADVIEW CHEMICAL
CORPORATION, *Plaintiff*

LOCTITE CORPORATION,
Defendant

By: FRANK E. CALLAHAN

By: LINDSEY, PRUTZMAN &
HAYES

By: ROBERT B. SNOW, JR.
205 Church Street
New Haven, Connecticut
Its Attorneys

By: JOHN M. PRUTZMAN
100 Constitution Plaza
Hartford, Connecticut
Its Attorneys

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DIEMATIC MANUFACTURING CORP.,

Plaintiff-Appellee,
against

PACKAGING INDUSTRIES, INC.,

Defendant-Appellant.

**AFFIDAVIT
OF SERVICE**

STATE OF NEW YORK,
COUNTY OF NEW YORK, ss.:

Ira Tolbert, being duly sworn, deposes and says that he is over the age of 18 years, is not a party to the action, and resides at 433 Lafayette Avenue, Brooklyn, New York. That on February 14, 1975, he served 3 copies of Brief for Plaintiff-Appellee on

Miller & Summit,
90 Broad Street,
New York, New York 10004
Att: Gerard A. Dupuis, Esq.

by delivering to and leaving same with a proper person or persons in charge of the office or offices at the above address or addresses during the usual business hours of said day.

... *Ira Tolbert* ...

Sworn to before me this
14th day of February, 19 75

John V. Desposito
JOHN V. DESPOSITO
Notary Public, State of New York
No. 36-0982350
Qualified in Nassau County
Commission Expires March 30, 19 75